Asset replacement

Many businesses use expensive machinery, equipment and motor vehicles in order to generate their income. The fixed cost of these assets is then either financed out of shareholder capital or through bank loans. Either way, the interest charge, if any, is not normally allowed as a deduction from tax because a special annual depreciation, or wear-and-tear allowance, is provided for in section 11(e) of the Income Tax Act.

The need

Most businesses use the depreciation deduction as a book entry in order to reduce their taxable income and therefore the amount of tax to be paid each year is reduced as well. While this makes accounting sense, what happens to the asset at the end of its useful life? In most cases, the business merely goes back to the shareholder or bank and refinances the purchase of a new asset. No planning or provision is made during the useful life of the asset to fund its replacement cost in the future. This should always form part of the business's holistic planning process.

The solution

The business takes out an investment policy (or an alternative investment vehicle) to accumulate capital to assist with the repurchasing of assets. The business may choose to invest sufficient amounts to cover all its assets in one investment or may prefer a combination of investments. Financing of the investments would be provided for by taking the tax savings generated by the depreciation allowance and investing this for the future.

The advantages

- Good corporate governance practices are instilled by making adequate provisions.
- Initiate the growth of alternative assets within the business, thus increasing its value to shareholders.
- Long-term liabilities are replaced on the balance sheet with fixed assets, thus improving the gearing ratios.
- The creditworthiness of the business is dramatically improved.
- Planning allows for systematic and structured investment for future expenses.
- An investment is created that can generate tax-free income after a five year period.

The implementation

- The business calculates the depreciation allowance and chooses either to invest the tax saving only, or the full allowance, depending on cash flow.
- The business chooses the most appropriate investment/s.
- When the asset is no longer productively utilised, the business can access the capital provision (by way of a loan or a withdrawal) and either purchase a replacement asset or pay a large deposit towards the purchase price.
- The investment continues to grow as a result of utilising the new depreciation allowance to fund future contributions.
- After five (5) years the business has an alternative asset that is reflected on the balance sheet and that may have a loan debt that could be used to house retained profits.

Asset replacement

Technical information

Income tax implications of the investment

The contributions to the investment are NOT tax deductible in the normal course of business as it is used to acquire a capital asset. If an endowment is used then the capital available after five years is tax-free in the owner's hands.

Although the withdrawal of value is a disposal for purposes of the capital gains tax provisions of the ITA, special exemptions apply because the business uses a product issued by a long-term insurer. The requirement is that the original beneficial owner of the contract receives the proceeds, which will be the case here.

Estate duty implications of the investment

This will be applicable only if an endowment contract is used and the sole insured life passes away. One can avoid this completely by adding multiple persons as insured lives, using a sinking fund contract, or partially by the exemption for the contributions paid plus 6% pa growth under section 3(3) of the Estate Duty Act.